

Bankruptcy Probability: A Theoretical and Empirical Examination

A thesis presented

by

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Certificate

I certify that this thesis has not already been submitted for any degree and is not being submitted as part of candidature for any other degree.

I also certify that the thesis has been written by me and that any help that I have received in preparing this thesis, and all sources used, have been acknowledged in this thesis.

A handwritten signature in black ink, appearing to read 'M. Patel', with a stylized, cursive script.

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Contents

Abstract	1
1 Introduction	3
1.1 Research Method	4
1.2 Organisation of thesis	8
2 Review of Bankruptcy Probability Literature	10
2.1 Explanatory Models of Financial Distress	11
2.1.1 Gambler's Ruin Approach	12
2.1.2 Firms with access to External Capital	16
2.1.3 Stability Analysis	20
2.1.4 Option theory approach to bankruptcy	25
2.1.5 Optimising firms in a uncertain environment	30
2.2 Empirical Regularities	33
2.3 Classification Studies	39
2.4 Summary	47
2.A Appendix: Financial Ratio Components	49
3 Theoretical Framework	50
3.1 Dynamic Programming	54
3.2 Model of a Firm Facing a Risk of Bankruptcy	60
3.2.1 Choice of Objective	61

3.2.2	Earnings uncertainty in the model	61
3.2.3	Definition of variables and constraints	62
3.2.4	The full model	68
3.3	Analysis of the Firm's Policy Regimes	69
3.3.1	Optimality conditions	69
3.3.2	Policy regimes	71
3.4	Summary	87
4	Empirical Validation of Model Results	93
4.1	Derivation of Testable Hypotheses	94
4.1.1	Control Variables	94
4.1.2	Probability Expressions	97
4.1.3	Variables for Statistical Testing	101
4.2	Development of a Test Statistic	105
4.2.1	Hazard functions	106
4.2.2	Explanatory variables and the form of the hazard function	108
4.2.3	Estimation	109
5	Results	112
5.1	Data and Sample Properties	113
5.1.1	Data	113
5.1.2	Censoring and Time Variation	115
5.2	Tests for Differences in Univariate Means	117
5.3	Cox Regression Results	119
5.4	Summary	123
6	Conclusion	126

6.1 Extensions	129
References	132

List of Tables

2.1	Scott Imperfect Access Model - Variables	17
2.2	Structure of a Profit and Loss Statement	34
2.3	A simple Balance Sheet Structure	34
2.4	Ratio Groupings - Beaver (1966)	35
2.5	Ratio Groupings -Pinches, Mingo and Caruthers (1973)	36
2.6	Classification Results - Beaver (1966)	40
2.7	Logit Results - Zavgren (1985)	44
3.8	Five unique Failure Probability Expressions	88
3.9	Variables in Failure Probability Formula	88
3.10	Summary Results from Prior Studies	89
3.11	Variables in Gambler's Ruin and Scott Probability Formula	90
4.12	Regime Specific Values of Control Variables	95
4.13	Failure Probabilities by Regime	97
4.14	Component Variables from Failure Probabilities	98
4.15	Proxy Variables from Financial Statements	104
4.16	Summary of Hypotheses to be Tested	105
5.17	Hypotheses to be Validated	112
5.18	Summary of Hypotheses for Proxy Variables	113
5.19	Summary of Results Hypotheses Tests - Full Variable Set	121

5.20	Summary of Results Hypotheses Tests - Reduced Variable Set	123
5.21	Results of Hypotheses Testing	124
6.22	Five Unique Failure Probability Expressions	127
6.23	Variables in Failure Probability Formula	127
6.24	Proxy Variables from Financial Statements	128
6.25	Results of Hypotheses Testing	129

List of Figures

2.1	Bifurcation set of a Cusp Catastrophe	22
4.2	Bankruptcy Probability - Left Tail	98
5.3	Sample properties of Continuing and Delisted Firms	117
5.4	Results of t-tests for Difference in Group Means.	118
5.5	Results of Cox Regression - All Variables	120
5.6	Correlation Matrix - Proxy Variables used in Cox Regression	122
5.7	Cox Regression Results - Reduced Variable Set.	122

Abstract

Early Bankruptcy classification models were developed to demonstrate the usefulness of information contained in financial statements. The majority of classification models developed have used a pool of financial ratios combined with statistical variable selection techniques to maximise the accuracy of the classifier being employed. Rather than follow an "ad hoc" variable selection process, this thesis seeks to provide an economic basis for the selection of variables for inclusion in bankruptcy models, which are based on accounting information. An implicit assumption underlying this work is that the probability of default is endogenous. That is, the decisions of a firm's management have a direct impact on the probability of bankruptcy. These decisions and their resultant effects can be identified through analysis of financial statements.

A model of a firm facing an uncertain environment with the possibility of bankruptcy is developed and analysed. In the model, a firm is created with given initial equity. These funds can be invested in productive resources or held as cash balances. The productive resources are used to earn random earnings in any period. If earnings are positive, they can be used to pay dividends to shareholders, invest in new productive resources, repay outstanding debt or increase the firm's cash balance. The firm is able to borrow and repay funds up to a credit limit. When the cash position of the firm falls to zero the firm is bankrupt. The firm attempts to maximise the stream of dividends paid to shareholders during its life. The solutions of the model and the associated bankruptcy probability expressions are derived by application of the dynamic programming algorithm.

The variables which differentiate the possible model solutions and those identified in the derived bankruptcy probability expressions, are 'proxied' by variables constructed from financial statement data. This data is derived from Annual Reports filed with the Australian Stock Exchange between 1966 and 1994. These proxy variables are used in the empirical validation of bankruptcy probability expressions derived from the model.

The random nature of the time horizon in the model for a single firm provides the rationale for the use of duration or hazard-based statistical methods in the validation of the derived bankruptcy probability expressions. The Cox (1972) proportional hazards model is used to estimate the coefficients and standard errors that are required for the validation of the derived bankruptcy probability expressions.

Results of the validation exercise confirm that the variables included in the empirical hazard formulation behave in a way that is consistent with the solutions of the model of the firm. Thus, the bankruptcy probability expressions derived from the model of the firm developed in this thesis provide a guide for the conduct of empirical investigations of the probability of corporate failure.